Building the Future for Canadians

Budget 1997

Tax Fairness

February 18, 1997

Canada

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Department of Finance Canada
Ministère des Finances Canada

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Introduction

On February 18, 1997, Finance Minister Paul Martin tabled his annual budget in Parliament. The budget proposes a number of measures to improve tax fairness. The budget provides targeted tax assistance for education, children, the disabled and charitable donations. In addition, the budget proposes changes in transfer pricing procedures for multinational corporations that will improve taxpayer compliance, facilitate administration by Revenue Canada and, thus, protect the Canadian tax base. These measures to enhance fairness in the 1997 budget are not one-off actions, but are part of a concerted government focus on improving the fairness of Canada's tax system.

This document situates the tax measures proposed in the 1997 budget as part of the government's continuing drive to improve the fairness of Canada's tax system. It highlights features of Canada's tax system that improve fairness and shows how the actions taken by the government in the last four budgets have further promoted this goal.

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Tax Fairness and the 1997 Budget

Canadian governments provide a variety of services to citizens and the principal source of revenue to finance them is taxes. In raising revenue, it is essential for governments to use a tax system that is fair which means applying the following key principles:

- **taxes must reflect the ability to pay** – those with similar incomes and in similar circumstances should pay similar taxes, but those with higher incomes must pay more. When feasible, those with higher incomes should pay progressively more taxes. Corporations must also pay taxes in Canada on their profits prior to their distribution to either domestic or foreign shareholders;

- **those who need help get it** – the tax system must recognize special circumstances that affect the ability to pay tax and should indeed be capable of actually providing assistance to, rather than levying taxes on, those in greatest need; and

- **taxes that are owed are indeed paid** – this involves compliance with the tax system. The government must ensure that Canadians clearly understand their legal obligations and that Revenue Canada collects taxes that are owed in a fair and efficient manner both for the government and taxpayers.

Maintaining tax fairness requires a constant monitoring of the tax system. Tax measures which were appropriate when introduced may no longer be suitable due to changes in the economy, new social priorities, aggressive tax planning and the need to improve compliance.

A portrait of the Canadian tax system follows with a particular focus on its many aspects that promote fairness. Highlights of the specific tax measures this government has introduced since 1994 to enhance fairness and information on steps taken in recent years to improve compliance are provided next. The last section summarizes measures in this budget to further increase the fairness of the Canadian tax system.

The Tax System and Fairness

Overview

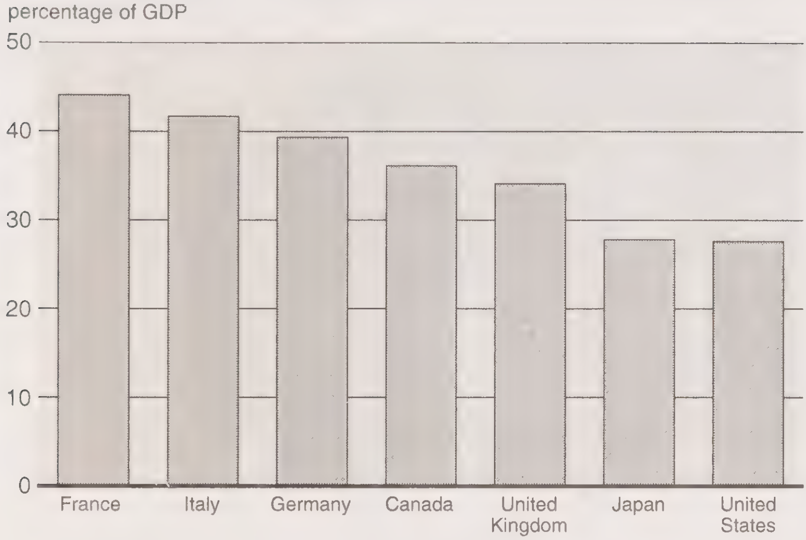
Total tax revenues for all levels of government in Canada stood at 36.1 per cent of GDP in 1994, the last year for which internationally comparable data are available. This puts Canada in the middle of the Group of Seven (G-7) large industrialized countries, but well above our major trading partners – the United States, Japan and the United Kingdom (Chart 1). Taxes as a share of GDP in Canada rose in the 1980s and 1990s (Chart 2), although they peaked at 36.7 per cent in 1991 and have declined slightly since then.

An efficient tax system should include taxes from several different sources. This ensures that the tax system has the flexibility to meet different policy goals and that no one tax source is relied on excessively.

In 1995-96, federal revenues totalled $130.3 billion (16.8 per cent of GDP). Personal income tax is the most important source of revenue for the federal government followed by employment insurance (EI) contributions, sales taxes and corporate income tax (Chart 3). These are reviewed in the rest of the chapter with the exception of employee contributions to EI. These are linked with EI benefits, and the impact of benefits and contributions on fairness should thus be examined jointly. In this regard, studies show clearly that Canada's tax transfer system is highly progressive.

Chart 1

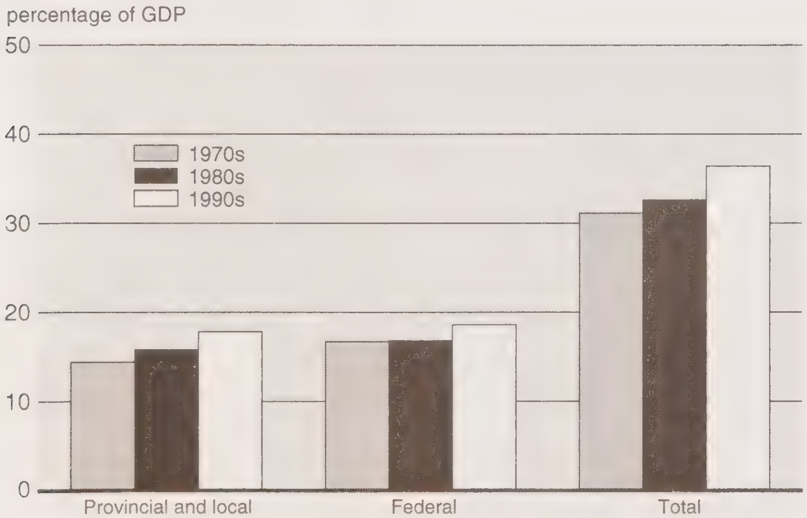
Total tax revenue in G-7 countries: 1994



Source: OECD, *Revenue Statistics*, 1995.

Chart 2

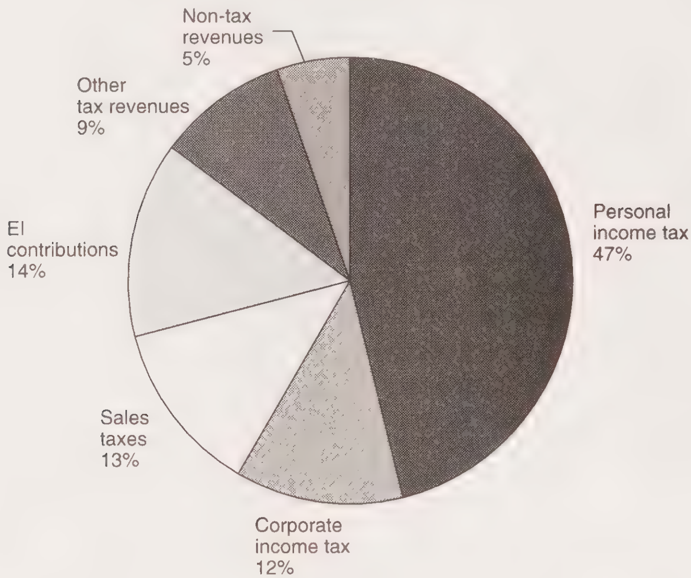
Revenues by level of government in Canada



Source: National Accounts.

Chart 3

Sources of federal revenues: 1995-96



Direct taxes on persons

The personal income tax system is the largest source of revenue for Canadian governments. It is also the most important tool in the pursuit of the objective of tax fairness. There are three key principles that drive personal income tax:

- individuals with similar income and in similar circumstances should pay similar amounts of tax;
- special circumstances of taxpayers are recognized, so that two Canadians with similar incomes but different ability to pay because of particular needs, may pay different levels of taxes depending upon their particular needs; and
- the tax system is progressive. This means that the percentage of income paid in taxes increases with income.

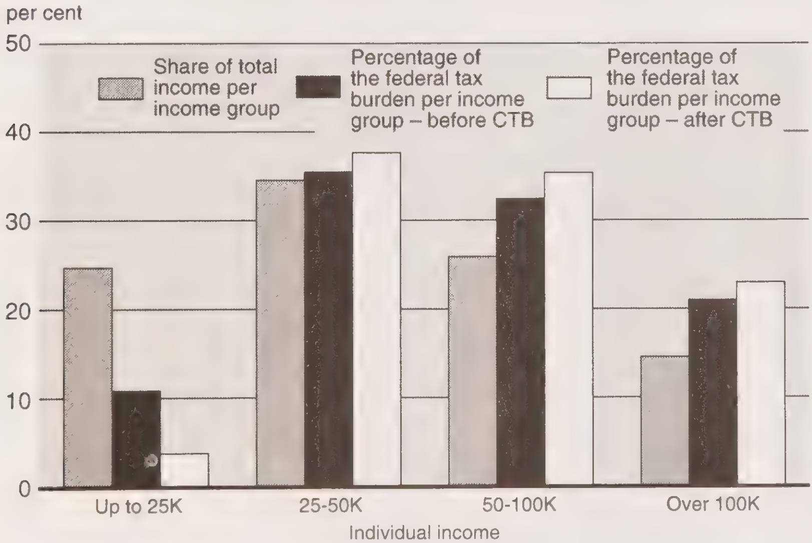
Comprehensive income is the basis for determining the ability to pay tax in the Canadian tax system. Income includes wages and salaries, self-employed earnings and capital income such as dividends, interest and capital gains. Some sources of income may not be fully taxed in order to achieve a variety of economic and social objectives. Certain transfers received by Canadians, such as social assistance and the Guaranteed Income Supplement (GIS), are

excluded in defining taxable income. Deductions and tax credits are provided to recognize the influence of a number of factors on the ability to pay taxes. In some cases, credits at a federal rate of 17 per cent are used rather than deductions to ensure that high-income Canadians do not receive higher tax relief, reinforcing progressivity in the Canadian tax system. For example, credits are provided to cover the costs of medical expenses, education and disabilities. These features have the effect of eliminating tax liability for many low-income Canadians and significantly reducing the effective tax rates for other Canadians with modest incomes.

The three tax brackets – 17 per cent, 26 per cent and 29 per cent – and high-income surtaxes reflect the progressive nature of the Canadian tax system. Taking into account the various deductions and exemptions, average filers pay 18 per cent of their income in combined federal and provincial personal income tax, compared with a 23-per-cent average tax rate for filers with income between $50,000 and $100,000, and a 33-per-cent tax rate for filers with income above $250,000. Chart 4 shows that Canadians at the high-income end pay substantially more taxes relative to their incomes than low-income Canadians.

Chart 4

Distribution of income tax burden by income level, 1994



The income tax system also has two refundable tax credits – the Goods and Services Tax (GST) credit and the Child Tax Benefit (CTB) which includes the Working Income Supplement (WIS) directed to low-income working families – which reinforce progressivity by reducing or eliminating the tax burden on low- and middle-income Canadians. The CTB recognizes that the costs of raising children reduce the ability of modest- and middle-income families to pay tax. These credits are paid to eligible taxfilers even where there is no income tax liability. The WIS reduces work disincentives by providing an income supplement to families where a parent leaves social assistance to find employment. This offsets part of the employment-related expenses and the loss of social assistance benefits they incur. This means that the lowest-income Canadians actually receive assistance from the income tax system rather than paying taxes.

Why do some high-income individuals not pay any taxes at all?

High-income earners pay a large proportion of federal taxes. For example, in 1994, those with incomes above $100,000 (about 2 per cent of filers) received 15 per cent of total income, but paid 21 per cent of total federal tax.

A few high-income earners may not pay income tax in a particular year by claiming legitimate deductions and credits. In 1994, for example, 290 individuals out of 54,000 taxfilers with incomes above $250,000 did not pay tax in that year. Deductions and credits which are available to all taxpayers may result in the elimination of tax liability for some individuals. For example, a taxfiler earning a large income from one source may incur a loss from an unincorporated business, give a large charitable donation and save for his retirement, thus ending up paying no tax in a particular year.

It should be noted, however, that while an individual may be non-taxable in one year, this is not generally the case in preceding and subsequent years as non-taxability typically results from an unusual mix of circumstances.

In order to ensure that deductions and credits are not used abusively to eliminate tax liability, the alternative minimum tax (AMT) disallows some deductions and credits in the calculation of the tax. More than 27,000 taxpayers were subject to the AMT in 1994.

How much tax are low-income Canadians paying?

In 1994, individuals with incomes below $25,000 represented about 60 per cent of all taxfilers, received about 25 per cent of total income and paid about 4 per cent of total federal tax, when Child Tax Benefit (CTB) payments are taken into account. In fact, many low-income Canadians actually receive money from the government through the tax system rather than paying taxes. About $8 billion in federal assistance to low- and modest-income households is provided through the two federal refundable tax credits – the CTB ($5.1 billion) and the GST credit ($2.9 billion). To provide additional help to low-income working parents, the 1996 budget announced a $250 million enrichment of the WIS, a component of the CTB, to take effect in two steps in 1997 and 1998.

Are family trusts being used to avoid the payment of taxes by the wealthy?

No. Family trusts are arrangements used to transfer property (for example, a family business or real property) to one or more members while trustees maintain control of the property. Trust arrangements are often used where beneficiaries are unable to manage the property for themselves, for example, because they are minors or disabled.

To ensure that all trust income is taxed appropriately, the 1995 budget eliminated an income-splitting opportunity by announcing the end of a measure that allowed undistributed trust income to be taxed in the hands of beneficiaries, except in the case of beneficiaries who are mentally or physically impaired. The 1995 budget also cancelled provisions which allowed trusts to defer paying taxes on capital gains for long periods of time. As a result, tax advantages associated with family trusts have been eliminated.

The income of trusts paid out to beneficiaries is taxed in their hands. The undistributed income of trusts, except for trusts created under an individual's will on death (testamentary), is taxed at the highest federal income tax rate of 29 per cent (provincial taxes are on top), rather than at the graduated tax rates at which individuals are taxed. This means that non-testamentary trusts pay a higher proportion of their incomes in taxes than do individual taxpayers.

Why does the federal government not have a wealth tax to enhance fairness?

Even though Canada does not have either an annual net wealth tax or a wealth transfer tax, taxes on wealth holders (e.g. municipal property taxes, corporate capital taxes) were higher as a per cent of GDP than in any other OECD country in 1994.

High-income taxpayers already pay substantial taxes. In 1994, individuals with over $100,000 in income represented just over 2 per cent of tax filers, received 15 per cent of total income, but paid 21 per cent of income taxes.

To prevent the tax-free transfer of income between generations, the government also taxes all unrealised capital gains at death, except when they are transferred to a spouse.

A wealth tax would simply add to the already high effective tax rates on investment returns.

Since 1994, the government has sought to ensure high-income earners shoulder their fair share of deficit reduction. Measures introduced include:

- eliminating the $100,000 lifetime capital gains exemption;
- eliminating inappropriate tax advantages that flow from establishing family trusts;
- reducing registered pension plan and registered retirement savings plan limits; and
- restricting inappropriate opportunities to defer taxes.

Sales tax

The second major type of tax on individuals is sales tax. This tax is linked to the amount of consumption, in contrast to income tax which is linked to the amount of income. As argued above, such diversification of the tax base is important for a number of reasons.

With respect to the GST, tax fairness is accomplished primarily through the income-tested refundable GST credit, worth $2.8 billion in 1994. By providing direct payments to families and individuals at low- and modest-income levels, and reducing these payments as income rises, the refundable GST credit helps offset the sales tax burden of lower-income families and individuals, thereby ensuring that sales tax burdens are sensitive to differences in income and family type.

Another instrument for addressing fairness in sales tax burdens is to exempt from taxation some commodities that are more heavily consumed by low-income individuals. Key examples are the tax-free treatment of basic groceries and prescription drugs, and the exemption of residential rents from the GST.

The GST also includes a system for rebating a portion of tax paid by municipalities, universities, schools and hospitals, as well as qualifying non-profit organizations and charities. GST rebates to these sectors help ensure that the cost of the important public services they provide is not unduly affected by sales taxes. The federal government has recently expanded these rebates to effectively lift all the GST from books purchased by schools, universities, libraries and other literacy-promoting organizations. The 100-per-cent GST rebate on books recognizes the instrumental role played by these institutions in helping individuals gain access to the tools they need to learn to read or pursue their education.

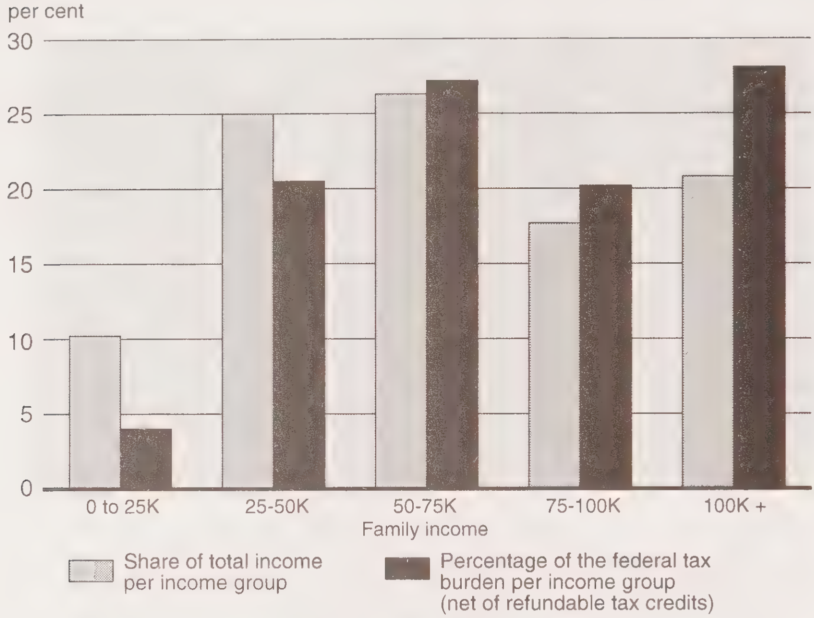
Does the GST impose an unfair burden on low-income Canadians?

No. The refundable low-income GST credit, worth $2.8 billion in 1994, significantly reduces the GST burden faced by low-income Canadians. For example, in 1994, over six million families and low-income singles with incomes below $20,000 received, on average, $320 under the refundable GST credit. Furthermore, the tax-free treatment of major consumption items such as basic groceries and prescription drugs ensures that these expenditures are not taxed at all, while the exemption of residential rents provides further sales tax relief. These three areas of expenditures are most important for low-income Canadians.

Chart 5 combines the incidence of income and sales taxes to determine the extent to which the federal tax system is progressive for Canadian families. Chart 5 confirms the conclusion drawn from Chart 4 on income tax alone: Canadian families at the high-income end pay considerably more taxes relative to their incomes, which is in accordance with the principles of fair taxation.

Chart 5

Incidence of federal income and sales tax by family income level, 1996



Taxes on business

A key element of a fair tax system is that corporations should pay their fair share of tax. Some have argued that corporations should not pay taxes at all since, sooner or later, corporate income ends up in the hands of individuals and is taxed under personal income tax. This view is inaccurate and corporations should pay tax for three key reasons. First, businesses benefit from public services in many of the same ways that individuals do. Second, in the absence of tax on corporations, it would be possible for individuals to postpone tax on income or capital gains indefinitely by placing income-producing assets in a corporation and thereby having the income or gains accrue within the corporation. Corporate income tax addresses this problem by imposing a tax on profits and capital gains prior to their distribution to individuals in the form of dividends. Third, corporate taxes allow the taxation of income accruing to foreigners and ensure that foreign-based corporations operating in Canada pay tax on income earned in Canada.

Capital taxes are used by both federal and provincial governments to supplement income tax revenues and to ensure that corporations pay for the public services they use. For example, the federal large corporation tax (LCT) ensures that all large corporations pay tax. Similarly, provincial capital taxes are an important source of revenue in some provinces. Capital taxes can also serve as a form of minimum tax as is the case for the federal capital tax on financial institutions where large banks, trusts and life insurance companies have to pay a minimum amount of tax based on capital which can then be offset by federal income tax. Overall, these capital taxes generated $1.5 billion in federal revenues in 1995.

Corporations pay a variety of other taxes and contributions in addition to income and capital taxes. These include payroll taxes (in respect of employers' contributions to EI, Canada/Quebec Pension Plans (CPP/QPP) and Workers' Compensation), property taxes, and indirect taxes such as sales and excise taxes. Excluding indirect taxes – for example, fuel taxes – corporations paid about $57 billion in total taxes and levies to federal, provincial and municipal governments in 1995. Chart 6 illustrates the breakdown of net earnings by corporations and Chart 7 illustrates the breakdown of the federal component of corporate taxes. Over the last three decades, corporations have paid an average of 36 per cent of their pre-tax profits in income and capital tax.

Corporate income tax receipts vary cyclically with the level of profits in the economy. Over the last few years, corporate income taxes have experienced the fastest rate of growth of all federal revenue sources, reflecting their sensitivity to stronger economic growth experienced over this period. Between 1988-89 and 1991-92, federal corporate income and capital taxes declined from $12 billion to less than $10 billion. They have since risen to $16 billion in 1995-96.

Chart 6

Corporate earnings ... who gets what – 1995

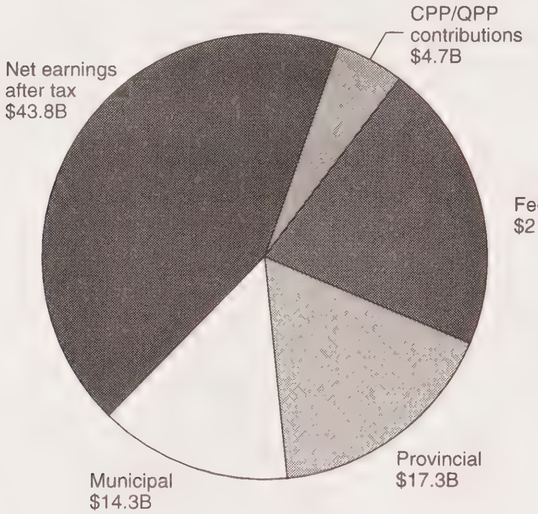
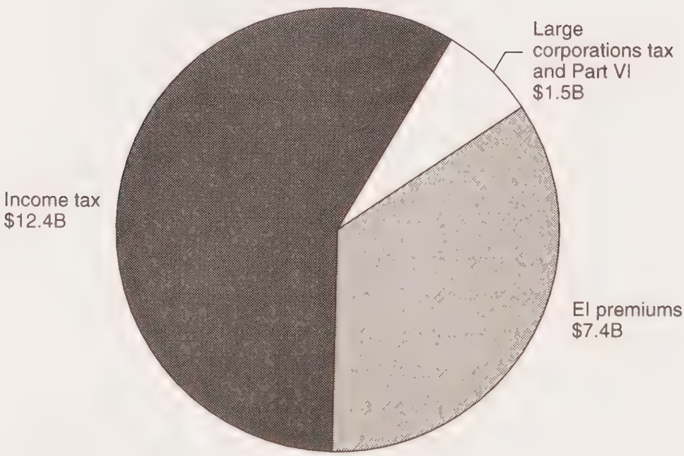


Chart 7

Corporate taxes: federal mix – 1995

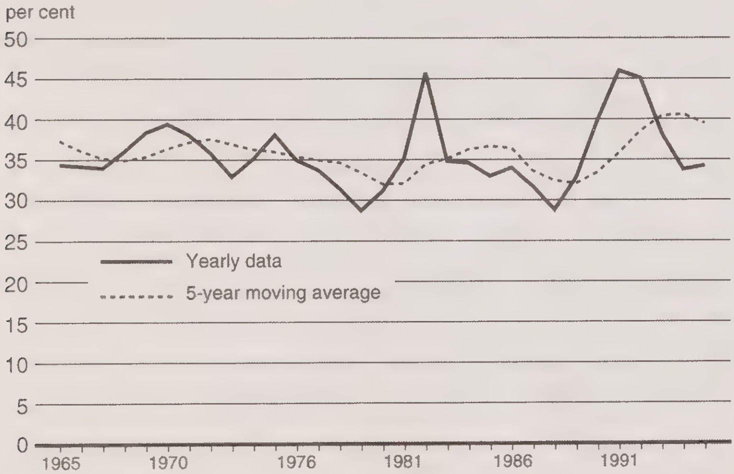


Has the tax burden on corporations been reduced in recent years?

Comparison of the ratio of corporate income taxes to total government revenues or to GDP can create the misperception that the total tax burden on corporations is falling. The major reason these ratios fell, particularly in the early 1990s, is that corporate profits have fallen as a percentage of Canada's GDP. In fact, the corporate income and capital tax burden has not declined. It has ranged, on average, between 32 to 41 per cent of pre-tax earnings since 1965.

In addition to corporate income and capital taxes, businesses pay a wide variety of other taxes such as employers' payroll taxes and property taxes. All the direct taxes paid by corporations amounted to more than $57 billion in 1995. Over the years, payroll taxes paid by employers for EI, CPP/QPP, Workers' Compensation and other provincial payroll taxes increased significantly from 1.4 per cent of total payroll in 1961 to 7.8 per cent in 1993.

Corporate income and capital taxes as a per cent of pre-tax profits: 1965-95



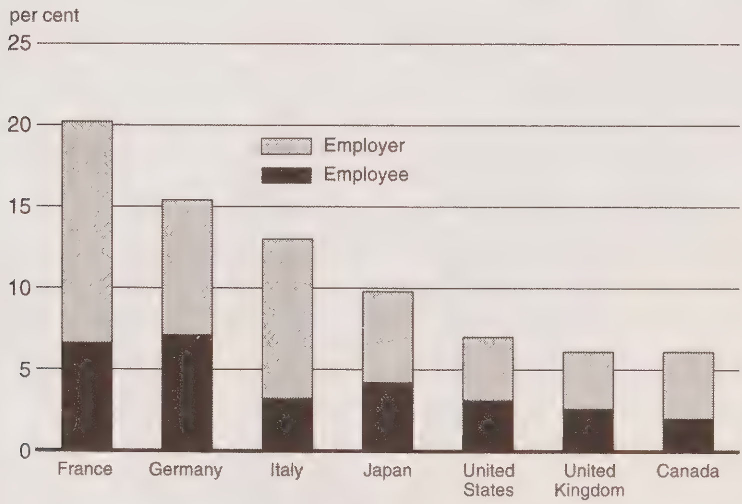
Are payroll taxes too high in Canada?

The total payroll tax burden in Canada is lower than in other countries, including the U.S. Of the G-7 countries, Canada and the U.K. have the lowest level of payroll taxes as a proportion of GDP. Total payroll taxes paid by employers and employees are lower in Canada than in the U.S. at all levels of employee income. This could be an important factor in a firm's decision to locate its production facilities in Canada or the U.S.

Most studies show that it is not the level of these taxes that has an adverse effect on job creation but rather the increase in the payroll tax rate, particularly during a recession. The government has lowered the tax rate on employees under EI from $3.07 to $2.90 per $100 of their maximum insurable earnings (MIE) and from $4.30 to $4.06 for employers. The decline in MIE itself has also lowered the payroll tax burden. The decline in the payroll tax has not been more rapid because of the constraints imposed by the fiscal situation.

In addition, almost 900,000 firms in Canada will be eligible for EI premium relief under the New Hires program. This means almost all eligible firms will pay virtually no premiums for new employees hired in 1997, and will benefit from a 25-per-cent reduction in premiums for new employees the following year. The maximum benefit per firm will be $10,000 in each year.

Payroll taxes as a per cent of GDP
G-7 countries, 1994



Measures to Enhance Fairness in the Last Three Budgets

The government has undertaken a large number of actions to improve tax fairness in the last three budgets. Table 1 provides a convenient summary of the most important of these measures. All major tax areas were changed including personal income tax, business income tax and sales tax. In all, Table 1 lists 35 major actions. In addition to these changes, the government has made or announced a number of other changes to the tax system since 1994 in budgets, technical bills and press releases to achieve a variety of objectives. A full listing of these other tax changes is provided in the Appendix. Many of these changes, although not major, also improved the fairness of the tax system.

The focus on the personal income tax side has been two fold: to ensure that those Canadians who are better off pay their fair share of taxes; and to provide additional tax assistance to those Canadians who can least afford to pay taxes. Key steps on the former included the elimination of the $100,000 lifetime capital gains exemption (LCGE), elimination of tax advantages available through family trusts, and the expansion of the base for the alternative minimum tax (AMT). On the latter, the main areas of action were greater tax assistance for education, children, charities and persons with disabilities.

On the business income tax side, the main objective has been to close down unintended tax loopholes and to ensure that corporations make a reasonable contribution to help deal with the federal government's fiscal problem. Major steps included tightening in a number of areas, including the reduction of possibilities to defer tax, and increases to the LCT and the corporate surtax. In total, these measures are now generating more than $1 billion in additional tax revenue each year.

New rules on taxpayer migration were recently announced. These rules will ensure that taxes on gains accrued in Canada are indeed paid to Canada.

Canada is also participating in initiatives of the OECD to devise co-ordinated responses to international tax avoidance through tax havens.

Modest but important steps were also taken in the sales tax field to reduce the tax burden on the disabled, the sick and charitable and public sector organizations, thus eliminating the need to pay sales tax on many essential items of purchase. The government has also provided a 100-per-cent GST rebate on all books purchased by public libraries, schools, universities, public colleges, municipalities and qualifying charities and non-profit organizations.

Table 1

Measures to enhance the fairness of the tax system since 1994 (year of introduction shown in parentheses)

Ability to pay: personal income tax

- eliminated the $100,000 lifetime capital gains exemption (LCGE). (1994)
- extended the base for the alternative minimum tax (AMT). (1994)
- eliminated tax advantages available through trusts. (1995)
- restricted the use of tax shelters. (1994)
- introduced new rules on taxpayer migration to ensure that gains that accrue while a taxpayer is a resident of Canada are subject to Canadian tax. (1996)
- extended the taxation of employer-paid life insurance premiums to the first $25,000 of coverage. (1994)
- reduced the overcontribution allowance for registered retirement savings plans (RRSPs) from $8,000 to $2,000. (1995)
- reduced the RRSP and money purchase registered pension plan (RPP) dollar limits to $13,500 in 1996 and froze them through 2003 and 2002 respectively. (1995, 1996)
- froze the maximum pension limit for defined benefit RPPs at $1,722 per year of service until 2005 (only affecting individuals earning over $75,000). (1996)
- eliminated the retiring allowance rollovers for years of service after 1995. (1995)
- introduced income-testing of age credit. (1994)
- reduced the maximum age limit for deferring tax on savings in RRSPs and RPPs from 71 to 69. (1996)

Table 1 *(cont'd)*
Measures to enhance the fairness of the tax system since 1994 (year of introduction shown in parentheses)

Ability to pay: business income tax

- increased the large corporation tax (LCT) and corporate surtax. (1995)
- introduced temporary surcharge on banks and other large deposit-taking institutions. (1995)
- eliminated the small business deduction for large private corporations. (1994)
- reduced the deduction for business meals and entertainment expenses from 80 to 50 per cent to better reflect the personal consumption element of these expenditures. (1994)
- increased the rate of tax on corporate dividends received by private investment corporations. (1994)
- taken steps to ensure that the income of financial institutions is measured appropriately for tax purposes. (1994)
- eliminated the deferral of tax on unincorporated business income. (1995)
- eliminated the deferral advantage for investment income earned by private holding companies. (1995)

Special help for those in need: personal income tax

- introduced new tax treatment of child support payments with payments non-deductible for the payer and non-taxable for the recipient. (1996)
- announced two-step enrichment of the Working Income Supplement (WIS) of the Child Tax Benefit (CTB) of $250 million. (1996)
- proposed new Seniors Benefit, which is more progressive, fully indexed and tax-free, will replace Old Age Security (OAS) and the Guaranteed Income Supplement (GIS) in 2001. (1996)
- replaced the seven-year limit by an unlimited carry-forward of unused RRSP room. (1996)
- enriched the infirm-dependant tax credit. (1996)
- lowered the threshold at which charitable donations begin to earn the 29-per-cent tax credit from $250 to $200. (1994)
- increased the limits on charitable donations eligible for tax credits from 20 to 50 per cent of net income, and to 100 per cent of net income in the year of death and the preceding year. (1996)
- increased the education amount from $80 to $100 per month. (1996)

Table 1 *(cont'd)*
Measures to Enhance the fairness of the tax system since 1994
(year of introduction shown in parentheses)

Special help for those in need: personal income tax *(cont'd)*

- raised the annual limit on the transfer of the tuition fee and education amounts to those who support students from $4000 to $5000. (1996)
- increased the annual limit on contributions to registered education savings plans (RESPs) from $1500 to $2000, and the lifetime limit from $31,500 to $42,000. (1996)
- broadened eligibility for the child care expense deduction to assist parents who undertake education or retraining. (1996)

Special help for those in need: sales tax

- proposed expanding zero-rating to persons with disability to purchase orthopaedic and orthotic devices. (1996)
- proposed expanding zero-rating of hospital beds to all health care facilities, including long-term care facilities. (1996)
- proposed most charitable and public organizations raise funds without collecting and remitting GST on sales. (1996)
- proposed 100-per-cent GST rebate on books purchased by public libraries, educational institutions and other specified bodies. (1996)

Taxes Owed are Indeed Paid: Measures in Recent Years

Canada's tax system is based on the principle of self-assessment in which Canadians assess their own taxes by filing tax returns with Revenue Canada, pay any taxes due and, of course, receive as a refund any funds due to them.

Revenue Canada's strategy to obtain compliance with the tax laws is based on voluntary compliance. Compliance is achieved through a balance of assistance, education and service activities along with responsible enforcement.

Revenue Canada has taken a number of initiatives to simplify tax administration, including outreach programs, improved telephone information systems and ongoing liaison with special taxfiler groups such as seniors and industry associations. By facilitating compliance, these initiatives help recover tax revenues. Details of these measures can be found in Table 2.

The system works well. The vast majority of Canadians comply fully with the law. However, as in any tax system, there are instances where taxes are not paid or not paid on time.

Tax law is complex and every effort must be made to simplify the system for those who may not have access to professional advice. There may be those who have experienced circumstances beyond their control preventing them from paying on time. Others may have no financial means to pay due to a pending bankruptcy. Also, there are those who avoid or evade taxes.

Different actions are required to recover taxes in these different situations. Table 2 also provides a summary of the most recent actions taken in this area. Chart 8 shows that Revenue Canada's verification and enforcement activities resulted in $4.8 billion in additional reassessments in 1995-96, a 25-per-cent increase over four years.

Tax evasion is the most serious aspect of non-compliance. It is the deliberate action of illegally hiding or underreporting income or inflating deductions or expenses.

Chart 8

Results of enforcement and verification programs in 1995-96

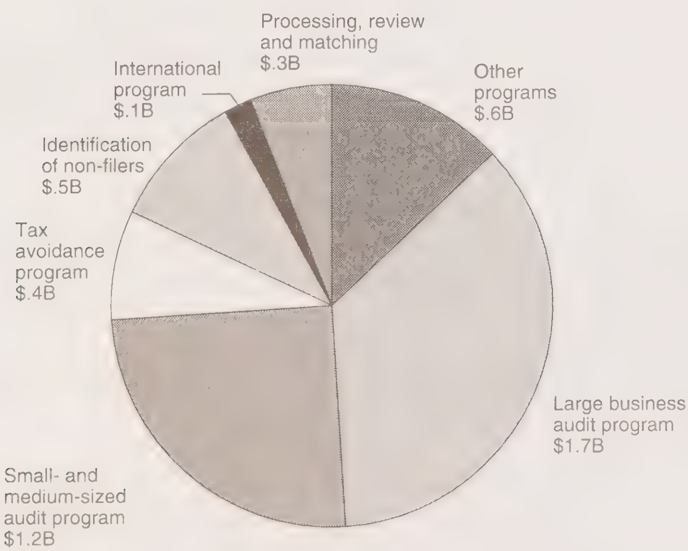


Table 2
Measures to enhance the effectiveness of tax collection

Simplifying tax administration for Canadians

- strengthened outreach and education programs.
- enhanced easy-to-understand automatic telephone information systems.
- provide advice to taxpayers who need it.
- meet with special taxfiler groups such as senior citizens and immigrants to help them comply.

Simplifying tax administration for business

- established a single Business Number for streamlining registration for GST remitters, employers, corporations and importers/exporters.
- new "Business Window" initiative to provide one-stop service, especially beneficial for small businesses.
- simplified payroll reporting for small businesses.
- reduced compliance costs for small- and medium-sized businesses by co-ordinating GST, income tax and excise tax audits.
- streamlined procedures to simplify and expedite customs clearance.

Improved enforcement

- implemented a new approach to large business audits including audit protocol.
- reinforced measures to target the underground economy.
- earlier identification of abusive tax avoidance and tax shelter schemes.
- continued improvement of sophisticated risk models to identify areas of high risk and a sector approach to compliance for small- and medium-sized businesses.
- forgiveness of penalties on voluntary tax disclosures to encourage taxpayers to comply voluntarily.
- agreements with many countries for exchange of information to help deal with tax havens.
- new rules requiring residents of Canada to file an information return when they own foreign assets in excess of $100,000 in value.

Revenue Canada, together with provincial authorities, have focused on a number of sectors of the economy where the risk of tax evasion is high, including construction, jewellery sales, auto repairs, home repairs, hospitality and other services. Sector-specific strategies have been developed such as the new reporting system for the construction industry. Revenue Canada also deals with tax evasion through criminal investigation programs. In 1995-96, special investigations reviewed over 28,000 referrals from external sources.

The government implemented an anti-smuggling initiative which has resulted in the seizure of contraband, such as drugs, tobacco, alcohol and firearms valued at more than $2 billion.

A particular area of government focus has been international tax havens. Tax recoveries on international transactions have tripled since 1992-93. Resources for international audit and verification will be tripled by 1998 compared to 1993 and Canada will strengthen its exchange of information with its tax treaty partners to ensure full reporting of foreign income.

New Budget Measures

This budget continues the task of improving fairness by providing additional tax assistance in a number of areas of priority:

- assisting students to defray the costs of education, helping workers to enhance their skills, and helping parents save for their children's education;
- helping children by providing significant additional funds towards an enriched and simplified National Child Benefit System as a step towards a more level playing field between families receiving social assistance and low-income working families;
- assisting people with disabilities to participate more fully in society by increasing tax assistance for disability-related costs and reducing disincentives to work;
- helping charities to raise donations by enhancing tax incentives to donors; and

■ updating Canadian rules on transfer pricing to bring Canadian law and practices in line with the evolving international standard to improve taxpayer compliance and to facilitate audits by Revenue Canada. These changes will preserve the fairness of Canada's tax system by ensuring that profits earned by taxpayers in connection with international transactions with non-resident related parties are properly measured and taxed in Canada.

Table 3 summarizes the new measures proposed in this budget.

Table 3
New budget measures to enhance the fairness of the tax system

Higher and more flexible tax assistance to students

- double the basis for the education credit over two years to $200 per month.
- make ancillary fees eligible for the tuition credit.
- allow a carry-forward of unused tuition and education credits.
- increase annual contribution limits for registered education savings plans (RESPs) from $2,000 to $4,000.
- allow transfers of RESP funds to a registered retirement savings plan (RRSP) or to the contributor.

Move toward a National Child Benefit System

- proposing a $6 billion Canada Child Tax Benefit by simplifying and enriching the current Child Tax Benefit, starting July 1998.
- enrichment of the Working Income Supplement (WIS) in July 1997 from the $125 million announced in the 1996 budget to $195 million and restructuring from a per family to a per child basis.

Additional tax assistance for people with disabilities

- broaden the medical expense tax credit.
- remove the limit on the attendant care deduction.
- introduce a refundable medical expense credit for earners.
- broaden the definition of preferred beneficiary for trusts benefiting people with disabilities.

Table 3 *(cont'd)*
New budget measures to enhance the fairness of the tax system

Increase tax assistance for charitable donations

- reduce the inclusion rate on capital gains arising from the donation of publicly listed securities from 75 to 37.5 per cent.
- change the income limit for donations to 75 per cent.
- include 25 per cent of Capital Cost Allowance (CCA) recapture in the net income limit.
- introduce a new method of valuation for easements of ecologically sensitive lands.
- increase resources for Revenue Canada to enhance information and compliance.

Transfer pricing

- update Canadian rules.
- require adequate documentation of transactions and introduce new penalty provisions related to Revenue Canada reassessments.
- increased resources for Revenue Canada for transfer pricing audits.

Appendix

Other changes to personal income tax expenditures

1994

- continued Home Buyers' Plan for first-time home buyers only.

1995

- exempted donations of ecologically sensitive land from the 20-per-cent limit.
- required non-resident recipients of OAS benefits to report their world income for purposes of the OAS high-income clawback.
- increased the rate of interest charged on income tax arrears.
- eliminated double claims of personal credits in year of personal bankruptcy.
- expanded taxation of non-residents' gains on Canadian capital property.

1996

- reduced the tax credit in respect of LSVCCs as well as the maximum purchase eligible for the credit. Increased the minimum holding period with respect to the credit. Denied eligibility for the credit for three years following the redemption of an LSVCC share.

- eliminated the administrative fee deduction for Registered Retirement Income Funds (RRIFs) and RRSPs.
- limited the withholding tax relief available to non-resident recipients of Canadian pension income.
- tightened rules governing the overseas employment tax credit.

Recent changes to corporate income tax expenditures

1994

- introduced a temporary 40-per-cent surcharge on tobacco manufacturing profits.
- lowered tax rate for manufacturing and processing – one percentage point reduction in the tax rate from 22 to 21 per cent.
- phased out access to refundable scientific research and experimental development (SR&ED) tax credits for larger private corporations having taxable capital between $10 and $15 million.
- eliminated the 30-per-cent Special Investment Tax Credit and the 30-per-cent Atlantic SR&ED credit.
- reduced the Atlantic Canada Investment Tax Credit from 15 to 10 per cent.
- eliminated the accelerated depreciation for air and water pollution abatement equipment effective 1999.
- reduced the accelerated depreciation rate for energy conservation equipment from 50 per cent straight-line to 30 per cent declining balance.
- tightened the rules applicable on forgiveness of debt.
- eliminated the use of "purchase butterflies" as a method to avoid tax on dispositions of appreciated corporate property.
- increased the refundable tax on dividends received by private corporations (Part IV tax).
- eliminated the special preference for sole-purpose SR&ED performers.
- constrained certain tax shelter schemes that had been developed utilizing convertible debt and negative adjusted cost bases.
- required property and casualty insurers to fully discount unpaid claims.

■ modified the basis upon which insurance companies may claim reserves for income tax purposes.

■ introduced a rule providing a deadline for making SR&ED claims.

■ eliminated tax benefits for limited recourse financings, applied the minimum tax to all tax shelter deductions, and increased penalties for selling unregistered tax shelters (December 1, 1994 release).

1995

■ replaced film tax shelter mechanism with an investment tax credit.

■ tightened the rules relating to non-arm's-length contract SR&ED, non-arm's-length provision of goods and services for SR&ED and certain third-party payments.

■ announced rules strengthening the ability of Revenue Canada to obtain information.

■ announced rules preventing the avoidance of source deduction remittances.

■ eliminated the preferred beneficiary election for most beneficiaries.

■ improved rules preventing artificial or premature recognition of tax losses.

■ introduced rules preventing capital costs being converted into up-front expenses by prepaying rent.

■ expanded taxation of non-residents' gains on Canadian capital property.

1996

■ tightened the resource allowance rules to provide a more consistent and stable resource allowance calculation and eliminated uncertainties related to court decisions.

■ tightened flow-through shares (FTS) to better focus the incentive – ensured that FTS are used to finance the more risky expenditures such as exploration and development costs and not property-related costs.

■ reduced the threshold levels and introduced a new restriction on reclassifications of expenses by oil and gas companies using FTS to better target this incentive to junior companies in start-up situations.

- excluded off-the-shelf seismic costs as eligible costs for FTS. Modified rules for accelerated CCA for mining activities – companies can earn accelerated CCA when they undertake large capital expenditures (i.e. above 5 per cent of gross revenues). In addition, oil sands projects using *in situ* extraction processes will also be eligible for accelerated allowances.
- enhanced incentives to invest in renewable energy – relaxed the specified energy property rules and expanded eligibility for FTS.
- extended the capital tax surcharge on large deposit-taking institutions by one year.
- announced pending changes to the taxation of life insurance companies and a three-year extension of additional capital tax in life insurance to take effect in 1996.
- limited amount of wages and salaries eligible for SR&ED tax credits for specified employees.
- terminated transitional provision for certain building rental payments in respect of SR&ED.
- determined the ordinary tax rate of non-residents for withholding tax purposes by reference to the greater of Canadian and worldwide income.
- repealed Joint Exploration Corporation rules.
- tax shelter rules concerning mismatched expenses and revenues announced November 18, 1996.

Recent changes to GST

- measures to simplify the operation of the tax for many businesses, charities and non-profit organizations.
- measures to improve the fairness of the GST for businesses and consumers.
- clarifications and measures to ease compliance.